

Riding out the storm: The impact of property sector distress on banks

We analyzed data from the H1 2022 earnings reports of China's 59 listed lenders to gauge the impact that distress in the property industry is having on the banking sector. Our conclusion is that overall, China's banks will be able to weather the turmoil with minimal disruption.

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Key takeaways

- Mortgage nonperforming loans (NPLs) are low and we expect them to remain so, even if the scale of the homeowner mortgage repayment boycott – which isn't reflected in the data because it only began in July – ends up being far greater than we assume.
- We estimate that two-thirds of all residential mortgages are concentrated in the Big Six state-owned commercial banks, which are far better equipped than their peers to ride out the boycott.
- Most banks continue to disclose relatively low levels of distressed real estate loans (i.e., loans to developers). Real estate (ex-mortgages) accounts for less than 10% of most banks' outstanding loans, and for most banks, less than 5% of their real estate loans are classified as nonperforming.
- It's fair to assume that bank disclosures don't fully reflect the true extent of their distressed real estate assets. However, the relatively low proportion of real estate loans as a share of total outstanding loans should mean that banks can comfortably manage significantly higher NPL levels than they currently acknowledge.
- Government efforts to ensure unfinished housing projects are completed should help contain banks' nonperforming mortgages and loans to developers.
- No doubt there are risks, but they likely reside in small banks that aren't part of our sample. Still, we believe authorities should be able to continue to manage any problems.
- A key trend we identified is that banks are picking winners. Despite central authorities repeatedly exhorting banks to increase lending to developers overall, more than 40% of the banks we analyzed reduced their outstanding real estate loans in H1 2022. That's partly due to their disposal of distressed real estate assets, but it's also a result of them paring back exposure to developers they lack confidence in.
- We expect that banks will continue to pick winners – lending to developers they deem healthy while reducing exposure to those they don't – not least because the central government is pursuing similar behavior by granting certain developers guarantees for their bond issuance.

This year, things have gone from bad to worse for China's property sector. Monthly housing sales have plunged, and government efforts to restore market confidence have fallen flat. These problems have been compounded by a mortgage boycott by homeowners who are repaying loans on properties that have yet to be delivered by developers. This action, which seems to have started in July, has spread to hundreds of developments across the country and although it's almost impossible to accurately gauge how much money or how many borrowers are involved, it's got regulators worried enough to start a bailout to get homes finished.

With little relief in sight, we wanted to look at the implications of these issues for China's banking system, and to answer two questions in particular:

- To what extent are developers' difficulties taking a toll on bank asset quality?
- How exposed are banks to the mortgage repayment boycott?

To find the answers, we analyzed data from the H1 2022 earnings reports of China's 59 listed banks who together account for about 81% of commercial bank assets [Fig. 1]. The sample doesn't include all of China's largest banks – Hengfeng Bank and Guangfa Bank, for example, rank among the biggest 25 lenders by assets, but they aren't listed on either the mainland or Hong Kong stock exchanges and so don't produce detailed mid-year earnings reports. Non-listed banks aren't likely to be as healthy – or as well managed – as those that are publicly traded and are more likely to be problematic. Nonetheless, we believe our sample provides a broadly representative snapshot of the banking sector's health.

Fig. 1 – Banks in our sample

	Number of banks in sample	Banks in sample as percentage of total assets in their class of bank
State-owned commercial banks	6	100%
Joint stock banks	10	95.7%
City Commercial Banks	31	62.1%
Rural financial institutions	12	12.8%

Source: Trivium

Based on our analysis of the data, China's banks look to be able to weather the property sector's troubles with minimal disruption. Mortgage NPLs are low – typically below 1% of outstanding mortgages – and we don't expect that to change. We estimate that two thirds of all home mortgages are concentrated in the Big Six state-owned commercial banks,¹ which are well equipped to ride out the boycott, even if the scale of the boycott ends up being far greater than we assume.

¹ Industrial and Commercial Bank of China, China Construction Bank, Agricultural Bank of China, Bank of China, Bank of Communications, China Postal Savings Bank

Similarly, most banks should be able to weather an increase in distressed real estate loans (i.e. loans to developers). Real estate (ex-mortgages) account for less than 10% of most banks' outstanding loans, and for most banks less than 5% of their real estate loans are classified as nonperforming. Moreover, government efforts to ensure that unfinished housing projects are completed should help control NPLs.

No doubt there are risks. Banks in our sample have likely not fully disclosed the true extent of their distressed loans to developers. Moreover, we believe that distress is likely being felt most acutely by some small banks that aren't part of our sample. Even then, we believe authorities should be able to continue to manage any problems.

A key trend we identified from the earnings data is that banks are picking winners. Despite central authorities repeatedly exhorting them to increase lending to developers, more than 40% of the banks in our sample reduced their outstanding real estate loans in the first half of the year. That's partly due to their disposal of distressed real estate NPLs but is also a result of them paring back their exposure to developers they no longer have confidence in.

We don't anticipate bank behavior to change. If anything, we expect it to be validated by central authorities, who are also picking winners by selectively allowing certain developers to issue bonds guaranteed by the China Bond Insurance Co., a state-owned provider of financial guarantees. Consequently, we expect financial conditions for many distressed developers to worsen further, making their eventual restructuring – or bankruptcy – inevitable.

The mortgage boycott

Banks' exposure to the property sector is mainly through homebuyer mortgages. For almost all banks, the NPL ratio for mortgages is well below 1%. The question is: will the mortgage repayment boycott result in a meaningful increase? We don't think it will.

Since July, homebuyers at hundreds of unfinished developments across the country have threatened to stop mortgage payments until they take possession of properties that they bought off-plan and should have already received. However, developers have been unable to finish those properties due to insufficient funds. The boycott started in Zhengzhou but quickly spread to other cities.

It's difficult to gauge just how much of an impact the boycott is having on banks' asset quality, but we believe it to be marginal because the bulk of their mortgage loans are for properties that have been completed. The only loans at risk are those for properties that aren't yet finished – which are mainly loans issued in the last two (and at a stretch, three) years.

Neither we nor anyone else, other than possibly the government, have an accurate picture of just how widely the boycott has spread. So far, the only bank that has given any insight into its exposure is the Agricultural Bank of China (ABC).

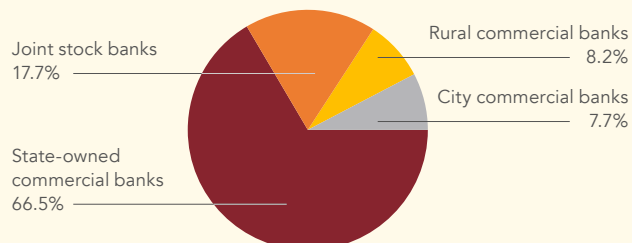
At the end of August, ABC reported it had RMB 1.23 billion in overdue loans resulting from homeowners declining to repay mortgages on

properties they should have already received. To put that into context, at the end of June ABC had RMB 5.34 trillion worth of mortgage loans outstanding. The impact on ABC could conceivably increase, but the scale of the boycott would have to hugely expand to have a meaningful impact on ABC's overall asset quality.

Moreover, Beijing moved quickly to introduce a mechanism to get housing projects finished, which has likely curbed any further significant spread of the boycott. Consequently, we believe that the boycott is limited in scope – which may explain why only Zhengzhou and Nanning have so far launched bailout funds to address the problem.

Even if we're wrong, we don't expect the mortgage boycott to be an unmanageable burden on banks' capital and liquidity. That's because mortgages are disproportionately concentrated in China's large state-owned commercial banks (i.e. the Big Six banks), which also happen to be the group of financial institutions best equipped to manage the pressure – they can borrow more cheaply from the interbank market than any of their peers and are able to borrow from the People's Bank of China (PBoC) through most of its lending windows. While the Big Six account for 48% of all commercial bank assets, we estimate that they account for 67% of all mortgages **[Fig. 2]** and ABC alone likely holds about 13% of the total. Meanwhile, city commercial banks and rural financial institutions – a group that includes rural commercial banks, village banks, and rural credit cooperatives, which together are the weakest of China's banks – account for 31% of total commercial banking assets, but only 16% of mortgages.

Fig. 2 – Estimated concentration of mortgage loans by bank type



Source: Bank earnings reports, Trivium, China Banking and Insurance Regulatory Commission

That's by design. On December 31, 2020, the PBoC and the China Banking and Insurance Regulatory Commission jointly imposed upper limits on the amount of residential mortgages a bank can have as a share of its total loans, and a ceiling on total real estate loans (that is, mortgages combined with corporate loans to the real estate sector). Banks were then divided into five tiers, with larger banks entitled to issue more real estate loans than their smaller peers **[Fig. 3]**. Consequently, small banks are far less exposed to the property sector, and to mortgages in particular.

Fig. 3 – Limits on commercial bank real estate loans as a proportion of total lending

		Combined real estate loans	Residential mortgages
Tier 1	Large state-owned commercial banks	40.0%	32.5%
Tier 2	Joint stock banks plus Bank of Beijing, Bank of Shanghai, and Bank of Jiangsu	27.5%	20.0%
Tier 3	City commercial banks and large rural commercial banks	22.5%	17.5%
Tier 4	County-based rural banks	17.5%	12.5%
Tier 5	Village banks	12.5%	7.5%

Source: People's Bank of China

Finally, the mortgage boycott is a liquidity problem, not a solvency problem. It's fair to assume that most presold housing will eventually be finished, and when that occurs – if not before – homeowners will resume mortgage payments. In August, the housing ministry (MoHURD), the finance ministry (MoF), and the PBoC devised a plan to provide policy banks with “special loans” to fund construction of overdue homes. Caixin has since reported that the PBoC will lend policy banks RMB 200 billion at low interest rates, which the banks will then lend to local governments to help fund construction.

Meanwhile, the Zhengzhou government has promised that construction of all stalled housing in the city will resume by the end of September.

There are too many variables to be able to judge how long the boycott will last. But at some point, it will become clear to buyers that their unfinished homes are on track to be completed and the boycott will start to peter out. Banks – or perhaps the authorities – could also start punishing homeowners who refuse to back down.

Hence, the challenge for banks is to endure the shortfall in income until home loan repayments resume. Given that mortgages are concentrated in the largest banks, the PBoC should be able to deftly manage any liquidity pressures.

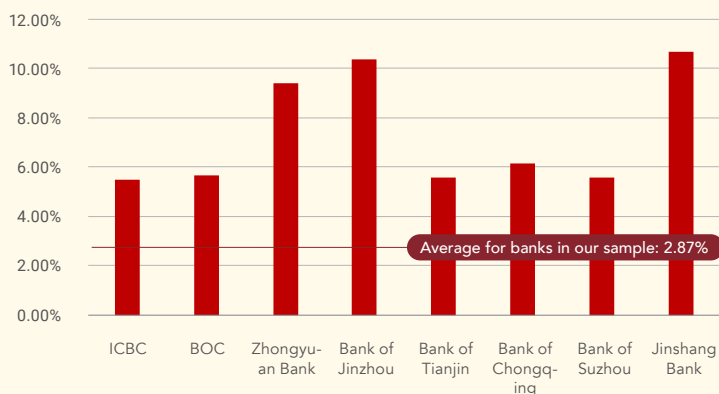
Arrested development

The situation with regard to developer loans is more complex. Exposure to developers is, on the whole, low – in our sample, real estate loans (which excludes mortgages and comprises primarily lending to developers) accounted for more than 10% of outstanding loans at only a handful of banks [Fig. 4]. The NPL ratio for real estate loans is also low for most banks.

Fig. 4 – Banks where real estate loans account for more than 10% of total gross loans at end-June 2022

Source: Bank reports, Trivium

Our analysis shows that those banks with a relatively high percentage of distressed real estate loans typically have fairly low levels of such loans. For example, the NPL ratio for real estate loans at Zhongyuan Bank was 9.38%, but such loans accounted for only 3.8% of its total outstanding loans [Fig. 5]. At Jinshang Bank, the real estate NPL ratio was 10.68%, but real estate loans were only 5.0% of the loan book. At Bank of Jinzhou, the real estate NPL ratio was 10.37%, but real estate loans represented only 3.8% of the total.

Fig. 5 – Banks with a real estate NPL ratio higher than 5%

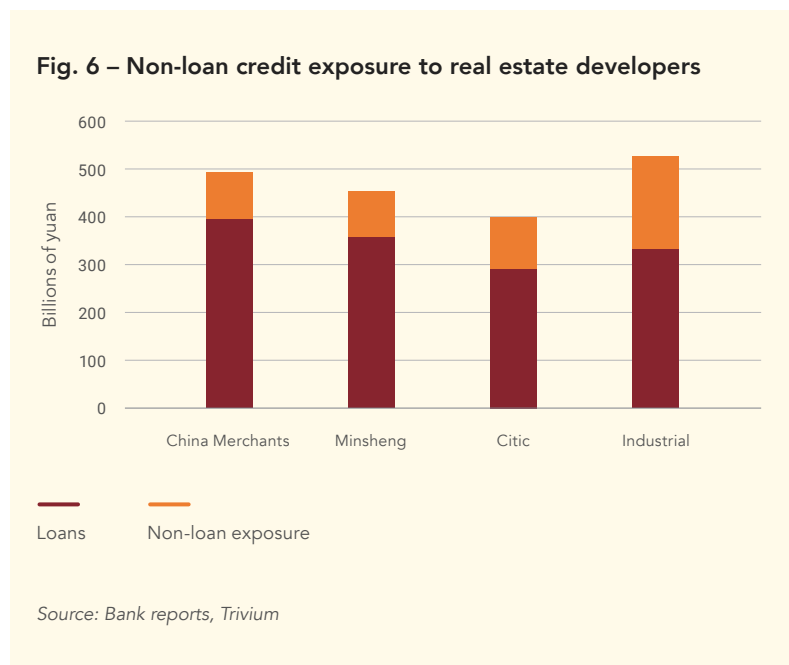
Source: Bank reports, Trivium

However, the reported NPL ratios of China's banks are notoriously unreliable. The true level of NPLs – for real estate specifically and for total outstanding loans in general – is undoubtedly higher than what the banks disclose. However, there's no way of knowing with any certainty just how high the real level is. It's also likely that the degree to which NPLs are underreported varies between banks.

Still, the relatively low concentration of loans to developers at most banks means that significantly higher real estate NPL levels are sustainable. The risk is that banks have deliberately obscured the true extent of their exposure to developers by mis-categorizing some of their real estate loans as something else.

A further deficiency in disclosure is that most banks provide no details of their credit exposure to developers excluding loans. Banks hold developers' bonds, contingent liabilities (which we assume include undiscounted bankers' acceptances), as well as "non-standard credit," a euphemism for loans that have been restructured as trusts or directional asset management plans by securities firms and appear as non-loan assets on banks' balance sheets.

Of the very few banks that do disclose information, China Merchants Bank said that at the end of June non-loan credit accounted for 19.6% of its exposure to real estate (not including mortgages). For Minsheng Bank it was 20.2%, Citic Bank 26.9%, and Industrial Bank 34.7% [Fig. 6].



There's no way of knowing whether these four lenders are representative of the banking sector as a whole, or how the credit risk of these assets compares with that of real estate loans. However, the risk posed by non-loan credit to developers is not trivial. In particular, given developers' funding constraints, some may find it difficult to honor their undiscounted bankers' acceptances, a non-loan form of credit that banks generally regard as being fairly low risk when economic conditions are normal. Defaults on bankers' acceptances is certainly rising, but there's no way to gauge how great a risk acceptances issued on behalf of developers pose. Even so, they are without doubt adding to banks' exposure to developers.

Regional risks

Risks posed by developers are probably more concentrated in the lenders that are not included in our sample.

Henan province-based Zhongyuan Bank's real estate NPL ratio is high because it merged with three local banks – Bank of Luoyang, Bank of Pingdingshan, and Jiaozuo Bank of China Travel Service – in the first half of 2022. At the end of 2021, Zhongyuan's real estate NPL ratio was 3.22% but jumped to 9.38% after the merger – even after RMB 10 billion worth of bad loans were sold to the Henan provincial asset management company (AMC) as part of the restructuring.

But Zhongyuan's NPL ratio might not fully represent its exposure to distressed developers. In its H1 2022 earnings report, the bank said it:

“...also helped troubled real estate companies tide over the difficulties through repayment schedule adjustments and maturity extensions.”

Bailout benefits

The outlook isn't entirely bleak. The government's efforts to ensure that unfinished housing gets completed should have a positive impact on the quality of real estate loans. Some NPLs were likely created as a result of stalled housing projects. Ensuring they are completed opens up the potential for banks to have their loans repaid, as funds held in escrow from presale are finally released. (To be sure, that depends on whether there are still funds in escrow waiting to be released or whether developers colluded with local authorities to access those funds prematurely and deploy them on other projects).

Jinshang Bank highlighted this as the reason why it expects its currently high real estate NPL ratio won't be a problem longer term.

“With the introduction of a series of policies by the central and local governments to resolve real estate risks, certain enterprises have gradually resumed production,” the bank said in its H1 2022 earnings report. “Therefore, the NPLs in the real estate industry will be properly disposed of one after another and the losses will be under control, which will not pose a significant risk to the Bank's business development.”

Moreover, even if developers are unable to repay loans that are currently classified as non-performing – something Jinshang clearly expects will occur in some cases as the result of government policy – the bank still expects to be able to recoup its losses.

“At present, most of the NPLs in the real estate industry are fully secured and a large amount of properties have been preserved by legal means,” it said.

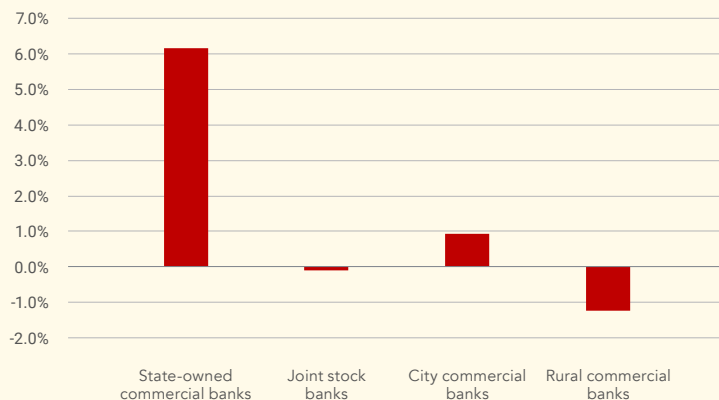
Picking winners

The most interesting trend that emerged from our dive into bank earnings wasn't the impact of developers' distress on banks, but rather the impact of banks on developers.

Total outstanding real estate loans of banks in our sample were 3.1% higher at the end of June than they were at the end of 2021 [Fig. 7]. However, almost half – 25 out of 59 – reduced their outstanding loans to developers over the period. The increase was concentrated in the Big Six banks – as a group, their outstanding loans to developers rose 6.1%, and increases were reported by all six. Total lending to developers by the 10

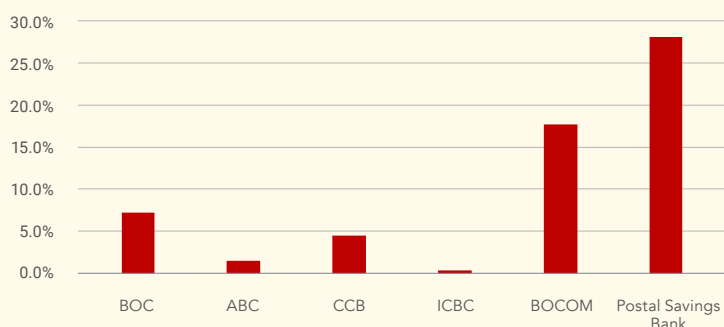
joint-stock banks in our sample contracted by 0.1% (although lending rose at four and fell at six) [Fig. 8].

Fig. 7 – Percentage change in outstanding real estate loans in H1 2022

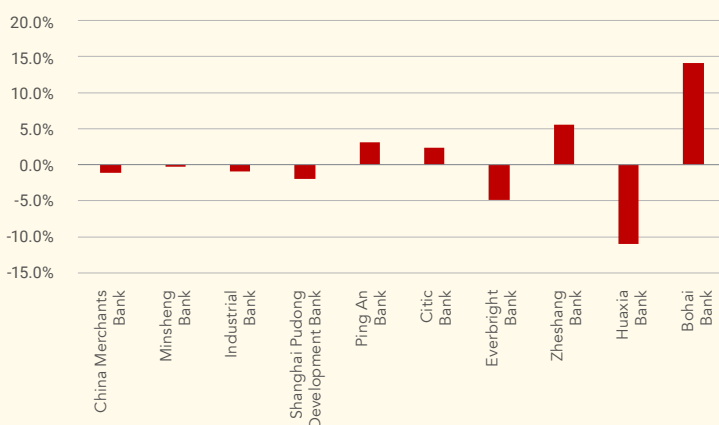


Source: Bank reports, Trivium

Fig. 8 – Percentage change in outstanding real estate loans in H1 2022 at the Big Six commercial banks



Percentage change in outstanding real estate loans in H1 2022 at joint stock banks



Source: Bank reports, Trivium

Since late 2021, China's authorities have been pushing banks to lend more to developers, so why have so many reduced their exposure? We believe two main forces are at play.

The first is that banks have ramped up their disposal of real estate NPLs. This is something Bank of Communications articulated in its H1 earnings:

"The Bank relocated the relevant several real estate project loans to non-performing loans...and has further strengthened...recovery and disposal of related loans."

The second is that banks have stopped making new loans to developers deemed overly risky. In other words, quite understandably, banks are picking winners. We'll let the banks speak for themselves. The following comments are from H1 earnings reports.

China Merchants Bank:

"The Group focused on high-quality customers and high-quality projects, reduced the proportion of assets of high-leverage and high-debt real estate customers with lower ratings and poor qualifications, strictly investigated the cash flow of real estate enterprises, selected housing projects with capacity to cover their debts and commercial sustainability, [and] focused on products such as housing projects for buyers with rigid demand and upgraders."

Industrial Bank:

"Since the beginning of the year, the Company has...promoted the decoupling of projects [able to cover their costs] from risky real estate enterprises."

Bank of Hangzhou:

"We implemented a white-list...and limited our targets to high-quality real estate enterprises with sound business operation and moderate asset-liability ratio."

Bank of Shanghai:

"The Group...made plans for the active withdrawal from risky real estate enterprises."

This suggests that some developers are able to access credit, while others have found themselves largely cut off. It seems unlikely this situation will change any time soon. If anything, this selectivity is likely to become more entrenched.

That's in large part because the central authorities are pursuing a similar strategy. In August, regulators drew up a list of six relatively healthy developers that are entitled to have their bonds guaranteed by China Bond Insurance Co. We assume that at some point, authorities will add more developers to the list. This policy will likely also influence banks' behavior, making them less likely to lend to developers that don't receive Beijing's seal of approval, thus making it all the more difficult for many developers to avoid restructuring, takeover, or bankruptcy.

Conclusion

Our analysis suggests that the recent mortgage boycott isn't likely to be a long-term burden on banks. The lion's share of mortgages is concentrated in China's Big Six state-owned commercial banks which are well positioned to manage any liquidity pressures that arise while the authorities strive to ensure unfinished housing is completed.

Risks arising from banks' exposure to developers is more complicated, not least because of disclosure problems. Still, assuming that loans to developers account for less than 10% of total outstanding loans for most lenders, most banks should be able to sustain real estate NPLs well above the levels that they currently disclose.

One important trend that we detected is that banks are striving to reduce their exposure to developers that they perceive as being too risky. While that's to be expected in a market economy, it flies in the face of repeated calls by Beijing for banks to boost lending to developers overall. Assuming this trend continues, the viability of certain developers will continue to diminish, which means we're likely to see far more developers being bailed out or entering bankruptcy restructuring in the year ahead. However, the risk for banks is that reducing their exposure to certain developers will accelerate the deterioration of those developers' finances, thereby making it harder for them to repay their outstanding stock of loans.